

FINANCIAL STATEMENTS AND
INDEPENDENT AUDITOR'S REPORT

Montana State Lottery

June 30, 2008 and 2007



A PROFESSIONAL CORPORATION OF
CERTIFIED PUBLIC ACCOUNTANTS

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Montana State Lottery

June 30, 2008 and 2007

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LEGISLATIVE AUDIT DIVISION

Tori Hunthausen, Legislative Auditor
Monica Huyg, Legal Counsel



Deputy Legislative Auditors:
James Gillett
Angie Grove

November 2008

The Legislative Audit Committee
of the Montana State Legislature:

Enclosed is the report on the financial audit of the Montana Lottery for the fiscal year ended June 30, 2008.

The audit was conducted by Galusha, Higgins, & Galusha, PC, under a contract between the firm and our office. There are no recommendations in this report.

Respectfully submitted,

/s/ Tori Hunthausen

Tori Hunthausen, CPA
Legislative Auditor

08C-02

Montana State Lottery
COMMISSION MEMBERS AND ADMINISTRATIVE OFFICIALS
June 30, 2008

COMMISSION MEMBERS

Robert Crippen, Chairperson

Wilbur Rehmann

Craig Anderson

Tom Keegan

Elizabeth O'Halloran

RESIDENCE

Butte

Helena

Glendive

Helena

Missoula

ADMINISTRATIVE OFFICIALS

George Parisot, Montana State Lottery Director

John Tarr, Montana State Lottery Director of Security

Montana State Lottery
INTRODUCTION AND BACKGROUND
June 30, 2008

INTRODUCTION

The purpose of our contract with the State of Montana and Montana State Lottery was to conduct a financial-compliance audit of the Montana State Lottery's financial statements and issue an opinion on such. The scope of our services is defined in our contract with the Office of the Legislative Auditor, dated May 29, 2008, and as supplemented by certain requirements included in the bidder information.

As a result of our audit, we have also issued a report on compliance and on internal control structure over financial reporting based on our audit of the financial statements performed in accordance with *Government Auditing Standards*.

BACKGROUND

The Montana State Lottery was created in November 1986 by a referendum vote of the people of Montana. The "Montana State Lottery Act of 1985" appears as Chapter 669 of the Montana Session Laws and Title 23, Chapter 7, of the Montana Code Annotated. The general purpose is to allow lottery games in which players purchase from the State, through the administration of the Montana State Lottery, a chance to win a prize. Disposition of revenue is a minimum of 45 percent for prizes and a maximum of 10 percent for commission to sales agents. The Montana State Lottery is required to transfer its net revenue to the Montana State General Fund.



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INDEPENDENT AUDITOR'S REPORT

To the Commissioners
Montana State Lottery
Helena, Montana

We have audited the accompanying financial statements of the Montana State Lottery (the Lottery), an enterprise fund of the State of Montana, as of and for the years ended June 30, 2008 and 2007, as listed in the table of contents. These financial statements are the responsibility of the Lottery's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

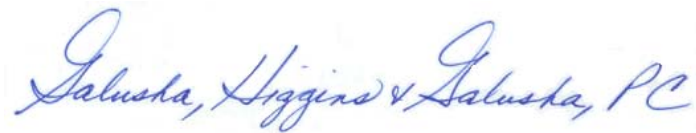
As discussed in Note A, the financial statements present only the Lottery and are not intended to present the financial position of the State of Montana and the results of its operations and cash flows of its proprietary fund types in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Lottery, an enterprise fund of the State of Montana, as of June 30, 2008 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued a report dated November 17, 2008 on our consideration of the Lottery's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grant agreements, and other matters. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

To the Commissioners
Montana State Lottery

The Management's Discussion and Analysis on pages 6 through 9 are not a required part of the basic financial statements but are supplementary information required by the accounting principles generally accepted in the United States of America. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. However, we did not audit the information and express no opinion on it.

A handwritten signature in blue ink that reads "Galusha, Higgins & Galusha, PC". The signature is written in a cursive, flowing style.

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
November 17, 2008

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following *Management Discussion and Analysis* of the Montana State Lottery's (Lottery) activities and financial performance provides the reader with an introduction to and overview of the financial statements for the fiscal years ended June 30, 2008 and 2007. The Lottery encourages readers to consider this information in conjunction with the financial statements, which directly follow.

FISCAL YEAR 2008 HIGHLIGHTS

The Montana Lottery completed another successful fiscal year with the highest level of sales ever reported for both scratch and online products, at 5.4% above fiscal year 2007.

The Lottery begins new scratch games on a regular basis. In fiscal year 2008, 46 games featuring different graphics, play styles, and prizes levels were placed at our retailer sales locations, including a new \$5 licensed property game, *Harley Davidson* with three top prizes and a Second Chance prize of a 105th Anniversary Harley Davidson. As a result, the Lottery saw a 3.5% increase in overall scratch sales.

In fiscal year 2008 the Lottery added the Montana Millionaire game which increased our expectations of online revenue. Powerball sales did increase slightly, about 3.6% even though the Lottery did not experience significantly high Powerball jackpots.

In fiscal year 2008, the Lottery's revenues reached a record new high of \$43.8 million. This resulted in a transfer to the General Fund of \$11.03 million.

OVERVIEW OF THE FINANCIAL STATEMENTS

The Lottery is classified as a special-purpose government fund engaged only in business-type activities. Accordingly, the Lottery operates in much the same manner as commercial enterprises using the full accrual method of accounting in accordance with accounting principles generally accepted in the United States of America. The basic financial statements consist of two components:

- 1) Three Fund Financial Statements: a *Statement of Net Assets*, a *Statement of Revenues, Expenses, and Changes in Fund Net Assets*, and a *Statement of Cash Flows*; and
- 2) Notes to the Financial Statements.

The *Statement of Net Assets* provides information about the nature and amounts included in both short-term and long-term assets and liabilities at the end of the year. Long-term fixed assets are capitalized and depreciated over their useful lives. Because the Lottery is required to transfer all "profits," or the excess of assets over liabilities, to the State's General Fund, its "net assets" will always be zero.

The *Statement of Revenues, Expenses, and Changes in Fund Net Assets* includes all of the current years' revenues and expenses. Revenues are recognized when earned and become measurable, not when they are received. Expenses are recognized when incurred, not when paid. This statement measures the success of the Lottery's operations over the past two years and details the total amount transferred to the General Fund.

The final statement is the *Statement of Cash Flows*. The primary purpose is to provide information about the cash receipts and payments during the reporting period. The statement also reports changes in cash resulting from operations, investing and financial activities, and provides answers to questions such as where cash came from and what cash was used for.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

NET ASSETS

The table below presents a summary of the Lottery's *Statement of Fund Net Assets*.

Condensed Statement of Net Assets as of June 30

| | 2008 | 2007 | Dollar Change | Percentage Change |
|--|--------------------|--------------------|-------------------|----------------------|
| | | | \$(238,571 | |
| Current Assets | \$4,624,686 | \$4,863,257 |) | -4.9% |
| Capital Assets net of depreciation | 227,090 | 139,127 | 87,963 | 63.2% |
| Other Assets | 1,765,916 | 1,509,968 | 255,948 | 17.0% |
| Total Assets | \$6,617,692 | \$6,512,352 | \$ 105,340 | 1.6% |
| Current Liabilities | \$5,286,692 | \$5,344,334 | \$(57,642) | -1.1% |
| Long-Term Liabilities | 1,331,000 | 1,168,018 | 162,982 | 14.0% |
| Total Liabilities | \$6,617,692 | \$6,512,352 | \$ 105,340 | 1.6% |
| Invested in Capital Assets, Net of Related Debt | \$ 227,090 | \$ 139,127 | \$ 87,963 | 63.2% |
| Unrestricted Net Assets | (227,090) | (139,127) | (87,963) | 63.2% |
| TOTAL NET ASSETS | \$ 0 | \$ 0 | \$ 0 | 0.0% |

The change in Current Assets is mainly due to an increase in Cash Collateral Security Lending and a decrease in cash and cash equivalents and inventories. The increase in Cash Collateral-Security Lending is a result of STIP securities on loan as of June 30, 2008 collateralized by cash and this amount represents the Lottery's share of the allocation of STIP cash collateral and related liability. The decrease in cash and cash equivalents is mainly due to the STIP balance including \$139,880 of Structure Investment Vehicles that were no longer liquid. As a result these are no longer considered cash equivalents and were reclassified to investments. The decrease in inventory is a result of closing and destroying closed game inventory and the timing difference between ordering and receiving new games while the Lottery analyzed and ensured the customers are receiving the games they want. The change in Other Assets is due to an increase of approximately \$116,068 in the Multi-State Lottery reserve fund and also an increase in Investments of \$139,880 due to the reclassification of STIP to investments.

The major change in Current Liabilities is a decrease in accounts payable and a decrease in the transfer obligation set off by an increase in prize liability and the liability under Security Lending. The increase in Long-Term Liabilities is a result of an increase in Compensated Absences and the establishment of the liability for OPEB or Other Post Employment Benefits. This liability is a result of the requirements of GASB 45 and recording of the "implied rate subsidy" which required the State of Montana to book substantial liabilities. The liability is a result of the state's requirement to allow retired employees to remain in the health insurance plan after retirement. This results in an implicit rate subsidy since retirees pay the same amount as active employees. "Actuaries Northwest" prepared the report for the State of Montana to calculate the Annual Required Contribution according to GASB. The allocation was made based on 2008 benefits expense and the number of FTE for an agency.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

NET ASSETS, continued

The category, *Invested in Capital Assets, Net of Related Debt*, consists of capital assets less accumulated depreciation, amortization and the outstanding balance on the debt related to the purchase of these assets, if any. Since the Lottery is required to transfer the total results of operations to the General Fund, the Net Assets should always be \$ - 0 - and the Unrestricted category is just a balancing figure. This figure can be used to measure asset liquidity and demonstrates where and if the Lottery's funds are obligated.

OPERATIONS AND CHANGES IN NET ASSETS

The table below presents a summary of the Lottery's Operations for the last two years.

Condensed Statements of Revenues, Expenses, & Changes in Fund Net Assets For the Years Ended June 30

| | 2008 | 2007 | Dollar Change | Percentage Change |
|---|---------------------|----------------------|--------------------|----------------------|
| Total Operating Revenues | \$43,827,111 | \$41,568,729 | \$2,258,382 | 5.4% |
| Total Direct Game Costs | 29,330,405 | 27,277,893 | 2,052,512 | 7.5% |
| Income Before Operating Expenses | \$14,496,706 | \$14,290,836 | \$ 205,870 | 1.4% |
| Total Operating Expense | 3,545,581 | 3,135,347 | 410,234 | 13.1% |
| Operating Net Income | \$10,951,125 | \$ 11,155,489 | \$(204,364) | -1.8% |
| Total Non-operating Revenues(Expenses) | 77,438 | 264,753 | (187,315) | -70.8% |
| Income Before Transfers | \$11,028,563 | \$ 11,420,242 | \$(391,679) | -3.4% |
| Transfer to General Fund | 11,028,563 | 11,420,242 | (391,679) | -3.4% |
| CHANGE IN NET ASSETS | \$ 0 | \$ 0 | \$ 0 | 0.0% |

Powerball and Scratch tickets experienced modest increases in sales, while Montana Cash, Wild Card, Hot Lotto and Qwik Tix decreased slightly. Montana Millionaire sales increased by 100% since it was the first year of this game. Direct Game Costs, which include prizes, vendor fees, retailer commissions, and scratch ticket printing, are directly related to sales and therefore, also show an overall increase.

Total Operating Expenses increased 13%. The majority of the individual expense categories increased with the exceptions of decreases in Advertising Production, Communications, Administrative Service Fees and Public Relations.

The income from Non-Operating activities decreased from the previous year. The decrease was a result of the decrease in interest earnings and the increase in the OPEB expenses.

The increase in sales and increase in operating expenses resulted in the Lottery transferring over \$11.03 million to the General Fund.

Continued

MANAGEMENT'S DISCUSSION AND ANALYSIS

CAPITAL ASSETS AND DEBT ADMINISTRATION

The Lottery follows the State's policy of capitalizing property and equipment with an historical value of \$5,000 or more and building and building/land improvements with an historical value of \$25,000 or more. In fiscal year 2008, the Lottery's capital assets were divided into two categories: 1) a fleet of vehicles used by the sales staff, and 2) office or computer equipment

Capital assets are depreciated using the straight-line method over the appropriate estimated useful life, ranging from three to seven years.

In fiscal year 2008, the Lottery purchased two replacement vehicles, two random number generator machines, and a new sign. The Lottery also disposed of one van in fiscal year 2008.

The Lottery currently has no debt-related commitments.

LOOKING AHEAD

The Lottery's goal is to maximize revenue for the State's programs while maintaining the public trust in lottery gaming. This requires offering games that Lottery players want to play, providing convenient locations for the purchase of tickets, and controlling operating expenses.

The Lottery estimates that 40+ new scratch games will be introduced in fiscal year 2009. The Lottery plans to continue building scratch sales through innovative game themes, offering games with built-in name recognition (licensed property games), and higher price points.

The Lottery will continue to look for opportunities to meet the expectations of our players for new and interesting games. The Lottery will again offer the *Montana Millionaire* game. The changes in the game this year consist of shortening the sales period by one month and starting sales on November 1st with the drawing on January 2nd. Additionally, instead of offering four \$5,000 drawings, every 375th ticket sold will win a \$50 prize.

Exceptional increases in lotto revenue are usually the result of higher jackpots; however, such jackpots cannot be predicted nor depended upon to occur at any specific time. The Powerball matrix will change in January, increasing the jackpots. The Lottery projects that the transfer to the General Fund in FY 2009 will be approximately \$11 Million.

CONTACTING THE LOTTERY'S FINANCIAL MANAGEMENT

This financial report is designed to provide a general overview of the Lottery's finances for all of Montana's citizens, taxpayers, players and creditors, and to report on the Lottery's accountability for its funds. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Montana Lottery, 2525 N. Montana Avenue, Helena, MT 59601.

Concluded

Montana State Lottery
STATEMENTS OF FUND NET ASSETS
June 30,

| | <u>2008</u> | <u>2007</u> |
|---|----------------------------|----------------------------|
| ASSETS | | |
| CURRENT ASSETS | | |
| Cash and cash equivalents | \$ 1,689,565 | \$ 1,839,056 |
| Accounts receivable, net of allowance | 1,412,247 | 1,381,754 |
| Due from other funds | 590 | 859 |
| Inventory | 1,399,625 | 1,614,375 |
| Collateral securities on loan | 65,762 | - |
| Prepaid expenses | 56,897 | 27,213 |
| Total current assets | <u>4,624,686</u> | <u>4,863,257</u> |
| FURNITURE AND EQUIPMENT | | |
| Furniture and equipment | 540,093 | 421,703 |
| Accumulated depreciation | <u>(313,003)</u> | <u>(282,576)</u> |
| Total furniture and equipment | <u>227,090</u> | <u>139,127</u> |
| OTHER ASSETS | | |
| MUSL Prize Reserve fund | 1,626,036 | 1,509,968 |
| Investments | <u>139,880</u> | <u>-</u> |
| Total other assets | <u>1,765,916</u> | <u>1,509,968</u> |
| TOTAL ASSETS | <u><u>\$ 6,617,692</u></u> | <u><u>\$ 6,512,352</u></u> |
| LIABILITIES AND FUND NET ASSETS | | |
| CURRENT LIABILITIES | | |
| Accounts payable | \$ 612,088 | \$ 654,938 |
| Estimated prize liability | 2,030,820 | 1,600,412 |
| Liability for securities on loan | 65,762 | - |
| Transfer obligations to general fund | 2,282,998 | 2,853,513 |
| Due to other funds | 24,512 | 9,140 |
| Deferred revenue | 190,851 | 107,068 |
| Current portion of accrued compensated absences | 79,661 | 119,263 |
| Total current liabilities | <u>5,286,692</u> | <u>5,344,334</u> |
| LONG-TERM LIABILITIES | | |
| MUSL prize liability | 1,094,763 | 1,105,943 |
| Long-term portion of accrued compensated absences | 131,868 | 62,075 |
| OPEB liability | <u>104,369</u> | <u>-</u> |
| Total long-term liabilities | <u>1,331,000</u> | <u>1,168,018</u> |
| TOTAL LIABILITIES | <u>6,617,692</u> | <u>6,512,352</u> |
| COMMITMENTS AND CONTINGENCIES | - | - |
| FUND NET ASSETS | | |
| Invested in capital assets, net of related debt | 227,090 | 139,127 |
| Unrestricted fund net assets | <u>(227,090)</u> | <u>(139,127)</u> |
| TOTAL FUND NET ASSETS | <u>-</u> | <u>-</u> |
| TOTAL LIABILITIES AND FUND NET ASSETS | <u><u>\$ 6,617,692</u></u> | <u><u>\$ 6,512,352</u></u> |

The accompanying notes are an integral part of these financial statements.

Montana State Lottery
STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN FUND NET ASSETS
for the years ended June 30,

| | 2008 | 2007 |
|----------------------------------|----------------------|---------------|
| OPERATING REVENUES | | |
| Scratch ticket games | \$ 12,837,664 | \$ 12,404,645 |
| Terminal ticket games | 30,983,930 | 29,159,946 |
| Miscellaneous | 5,517 | 4,138 |
| Total operating revenues | 43,827,111 | 41,568,729 |
| DIRECT GAME COSTS | | |
| Scratch ticket prize expense | 7,764,464 | 7,345,750 |
| Terminal ticket prize expense | 15,073,993 | 14,071,166 |
| Retailer commission | 2,564,201 | 2,469,427 |
| Gaming vendor fees | 2,804,090 | 2,489,916 |
| Cost of tickets sold | 1,123,657 | 901,634 |
| Total direct game costs | 29,330,405 | 27,277,893 |
| Income before operating expenses | 14,496,706 | 14,290,836 |
| OPERATING EXPENSES | | |
| Advertising | 635,240 | 617,124 |
| Advertising production | 93,328 | 108,443 |
| Communications | 89,047 | 90,980 |
| Audit fees | 52,177 | 32,013 |
| Contractual services | 133,929 | 95,106 |
| Depreciation and amortization | 43,206 | 31,164 |
| Interest expense | 4,327 | - |
| Management fees | 50,449 | 54,014 |
| MUSL operating fees | 32,175 | 6,077 |
| Other | 57,743 | 13,330 |
| Public relations | 59,399 | 67,156 |
| Personal services | 1,736,905 | 1,621,816 |
| Repairs and maintenance | 43,154 | 15,702 |
| Supplies and materials | 306,249 | 217,426 |
| Utilities and rent | 140,416 | 113,036 |
| Travel | 67,837 | 51,960 |
| Total operating expenses | 3,545,581 | 3,135,347 |
| OPERATING NET INCOME | 10,951,125 | 11,155,489 |

Continued

The accompanying notes are an integral part of these financial statements.

Montana State Lottery
STATEMENTS OF REVENUES, EXPENSES AND
CHANGES IN FUND NET ASSETS
for the years ended June 30,

| | 2008 | 2007 |
|---|--------------------|--------------------|
| NON-OPERATING REVENUES (EXPENSES) | | |
| Interest income | \$ 181,987 | \$ 267,019 |
| Securities on loan income | 4,486 | 212 |
| Securities on loan expense | (3,511) | (211) |
| Loss on disposal of furniture and equipment | (1,155) | (2,267) |
| OPEB expenses | (104,369) | - |
| Total non-operating net income | <u>77,438</u> | <u>264,753</u> |
| INCOME BEFORE TRANSFERS | <u>11,028,563</u> | <u>11,420,242</u> |
| TRANSFERS OUT | | |
| General fund | <u>11,028,563</u> | <u>11,420,242</u> |
| Total transfers out | <u>11,028,563</u> | <u>11,420,242</u> |
| Fund net assets, beginning of year | <u>-</u> | <u>-</u> |
| Fund net assets, end of year | <u><u>\$ -</u></u> | <u><u>\$ -</u></u> |

Concluded

The accompanying notes are an integral part of these financial statements.

Montana State Lottery
STATEMENTS OF CASH FLOWS
for the years ended June 30,

| | 2008 | 2007 |
|---|-----------------------------|-----------------------------|
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Cash received from sales | \$ 43,881,901 | \$ 40,997,135 |
| Cash paid to suppliers for goods and services | (7,990,495) | (7,497,307) |
| Cash paid to employees | (1,599,957) | (1,619,055) |
| Cash paid for prizes | (22,727,126) | (21,333,107) |
| Net cash provided by operating activities | <u>11,564,323</u> | <u>10,547,666</u> |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Interest and dividend income | 85,739 | 249,484 |
| Purchase of long term investments (reclassification of STIP) | (139,880) | - |
| Net cash (used) provided by investing activities | <u>(54,141)</u> | <u>249,484</u> |
| CASH FLOWS FROM NON-CAPITAL FINANCING ACTIVITIES | | |
| Transfers out: | | |
| General fund | (11,599,078) | (11,276,198) |
| Net cash used by non-capital financing activities | <u>(11,599,078)</u> | <u>(11,276,198)</u> |
| CASH FLOWS FROM CAPITAL AND RELATED FINANCING ACTIVITIES | | |
| Purchase of fixed assets | (61,696) | (50,114) |
| Proceeds from sale of fixed assets | 1,101 | 3,164 |
| Net cash used by capital and related financing activities | <u>(60,595)</u> | <u>(46,950)</u> |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (149,491) | (525,998) |
| Cash and cash equivalents, beginning of year | <u>1,839,056</u> | <u>2,365,054</u> |
| Cash and cash equivalents, end of year | <u><u>\$ 1,689,565</u></u> | <u><u>\$ 1,839,056</u></u> |
| RECONCILIATION OF OPERATING INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES | | |
| Operating income | \$ 10,951,125 | \$ 11,155,489 |
| Adjustments to reconcile operating income to net cash provided by operating activities: | | |
| Depreciation and amortization | 43,206 | 31,164 |
| Changes in assets and liabilities: | | |
| (Increase) decrease in: | | |
| Accounts receivable | (30,493) | (477,475) |
| Due from other funds | 269 | (859) |
| Due from component units | - | 376 |
| Inventory | 214,750 | (220,021) |
| Collateral securities on loan | (65,762) | 33,830 |
| Prepaid expenses | (48,529) | (711) |
| Long-term receivable | - | (115,690) |
| Interest receivable included in long-term receivable | - | 17,537 |
| Increase (decrease) in: | | |
| Accounts payable | (114,579) | 356,437 |
| Lottery prizes payable | 419,228 | (101,014) |
| Liability for securities on loan | 65,762 | (33,830) |
| Deferred revenue | 83,783 | (96,718) |
| Due to other funds | 15,372 | 2,538 |
| Compensated absences payable | 30,191 | (3,387) |
| Net cash provided by operating activities | <u><u>\$ 11,564,323</u></u> | <u><u>\$ 10,547,666</u></u> |

The accompanying notes are an integral part of these financial statements.

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization - The Montana State Lottery (hereafter referred to as the Lottery) was created in November 1986 by a referendum vote of the people of Montana.

Section 23-7-101, Montana Code Annotated (MCA) establishes the provision of the code under which the Lottery operates. The Lottery is overseen by a five-member commission consisting of Montana residents appointed by the Governor. The Commission, by law, has the power to operate a state lottery, determine the type and forms of lottery games, set ticket prices, determine the number and size of prizes, conduct lottery drawings, enter into agreements to offer lottery games with other states, and prepare financial reports. The Lottery is attached to the Department of Administration for administrative purposes.

Disposition of revenue is a minimum of 45 percent for prizes and a maximum of 10 percent for commission to sales agents. The remaining revenues, less expenses, are transferred to the Montana State General Fund.

Reporting Entity - The Lottery is included in the State of Montana's financial statements as an enterprise fund. In accordance with governmental accounting and financial reporting standards, there are no component units to be included within the Lottery's financial statements as a reporting agency.

Basis of Accounting - The Lottery utilizes the accrual basis of accounting and is classified as an enterprise fund of the governmental proprietary fund type. Enterprise funds account for operations similar to private business enterprises where the intent of the Legislature is that costs are to be financed or recovered primarily through user charges, or where the Legislature has decided that periodic determination of revenue earned, expenses incurred or net income is appropriate.

Revenue Recognition - Sales of scratch lottery tickets are made to licensed retailers who market the tickets to the public on a commission basis. Revenue is recognized when tickets are activated by retailers. Tickets activated, but not sold by retailers, may be returned for credit. Sales are reduced for estimated ticket returns.

Sales of terminal issued tickets, Powerball, Wild Card, Hot Lotto, Qwik Tix, Montana Cash, and Montana Millionaire, are made through licensed retailers who market the tickets on a commission basis using computerized terminals. Revenue is recognized on drawing dates for Powerball, Wild Card, Hot Lotto, Montana Cash, and Montana Millionaire. Tickets sold in advance of future drawing dates are recorded as deferred revenue until the ticket becomes valid for a drawing. Qwik Tix revenue is recognized at the time of the sale by the retailer through the terminal.

Cash and Cash Equivalents - Cash and cash equivalents consist of interest-bearing deposits with the Montana Board of Investments short-term investments pool, cash deposited with banks and cash on deposit with the Montana State Treasurer that is part of the State's pooled cash and is not separately identifiable as to specific types of securities. These funds are highly liquid and may be drawn on daily.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

Allowance for Uncollectible Accounts - The Lottery uses the allowance method to account for uncollectible receivables. The allowance is based on management's estimate of possible bad debts.

Advertising Costs - Advertising costs are expensed as incurred.

Allowance for Returned Tickets - The Lottery's policy is to accept any unplayed scratch ticket from a retailer for credit without regard to when the ticket or pack of tickets was activated. Therefore, an allowance to recognize the possibility of returns is calculated at the end of each fiscal year.

Inventory - Inventory consists of tickets and supplies. Ticket inventory includes scratch lottery tickets that are carried at cost using the specific identification method. Tickets are charged to cost of sales when activated. Unsold tickets are charged to cost of sales upon the end or cancellation of the related game. Supply inventory is carried at cost and expensed as used.

Prizes - Prize expense is recognized based on a predetermined prize structure for each scratch ticket and terminal game. Free tickets, when used as part of a game's prize structure, are recorded as a reduction in revenue and not as prize expense.

Unclaimed Prizes - Prizes for Powerball, Wild Card, Hot Lotto, Montana Cash, and Montana Millionaire must be claimed within six months after the appropriate draw date. Prizes for Qwik Tix must be claimed within six months of the sales date. Prizes for scratch games must be claimed within six months of the announced end of each game. The unclaimed prize amounts are taken as a reduction in the Lottery Prizes Payable liability and the Prize Expense and are transferred to the State of Montana General Fund as a portion of the quarterly transfer. The combined amounts of unclaimed prizes for terminal games were \$588,115 and \$743,977 and for the scratch games were \$469,497 and \$444,373 for the fiscal years ended June 30, 2008 and 2007, respectively.

Furniture and equipment - Furniture and equipment are recorded at cost. Donated furniture and equipment are recorded at their estimated fair market value at the date of donation. Ordinary maintenance and repairs are charged to operations as incurred; major renewals and betterments are capitalized. Upon disposition or retirement of furniture and equipment, the cost and related accumulated depreciation or amortization are removed from the accounts. Gain or loss on disposal is reflected in nonoperating revenues and expenses. Depreciation and amortization are calculated on a straight-line basis over estimated useful lives of three to seven years. The Lottery conforms to the State of Montana capitalization threshold for recording furniture and equipment as well as buildings and building/land improvements. The threshold for capitalizing furniture and equipment is \$5,000 and the threshold for capitalizing buildings and building/land improvements is \$25,000.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE A - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, continued

Compensated Absences - State employees earn vacation leave ranging from fifteen to twenty-four days per year based on years of service. Vacation leave may be accumulated to a total not to exceed twice the maximum number of days earned annually. Sick leave accumulates at a rate of twelve days per year with no maximum accumulation. Upon retirement or termination, an employee is paid for 100 percent of unused vacation leave and 25 percent of unused sick leave.

Use of Estimates - The preparation of financial statements in conformity with Generally Accepted Accounting Principles (GAAP) requires management to make estimates and assumptions that affect certain reported amounts and disclosures. Accordingly, actual results could differ from those estimates.

NOTE B - CASH AND CASH EQUIVALENTS

Cash and cash equivalents consist of the following:

| | June 30, | |
|--------------------------------------|----------------------------|---------------------------|
| | 2008 | 2007 |
| Short-term investment pool | \$ 1,358,596 | \$1,583,133 |
| Cash on deposit with State Treasurer | 320,819 | 245,773 |
| Cash in revolving deposit account | 10,000 | 10,000 |
| Petty cash | 150 | 150 |
| | <u>\$ 1,689,565</u> | <u>\$1,839,056</u> |

The Lottery participates in the Montana Board of Investments Short Term Investment Pool (STIP). STIP balances are highly liquid investments with maturities of 397 days or less. \$139,880 of STIP was reclassified to Investments to reflect investments in Structure Investment Vehicles that were no longer liquid. The bank balance of the revolving deposit account was \$32,673 and \$19,067 at June 30, 2008 and 2007, respectively, and was covered by federal depository insurance up to \$250,000 for the year ended June 30, 2008 and up to \$100,000 for the year ended June 30, 2007. The carrying amounts reported in the Statements of Fund Net Assets for cash and cash equivalents approximate the fair market value.

NOTE C - INVESTMENT RISK DISCLOSURES

Effective June 30, 2005, the State of Montana implemented the provisions of Governmental Account Standards Board (GASB) Statement No. 40, *Deposit and Investment Risk Disclosures*. The Lottery participates in two investment pools: the Multi-State Lottery Association (MUSL) reserve accounts and the State of Montana's Short Term Investment Pool (STIP). There are four types of risk that must be disclosed. These risks are defined below followed by their applicability to each of the investment pools.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE C - INVESTMENT RISK DISCLOSURES, continued

Credit risk is defined as the risk that an issuer to an investment will not fulfill its obligation, i.e., not make timely principal and interest payments.

Custodial credit risk is the risk that the Lottery would not be able to recover the value of the investment or collateral securities that are in the possession of an outside party in the event of the failure of that party.

Concentration of credit is the risk of loss attributed to the magnitude of a government's investment in a single issuer.

Interest rate risk is the risk that changes in interest rates will adversely affect the fair value of an investment.

Multi-State Lottery Association

The MUSL investment policy for prize reserve and unreserved funds states that permitted investments "include direct obligations of the United States government, perfected repurchase agreements, and obligations issued or guaranteed as to payment of principal and interest by agencies or instrumentalities of the United States government, and mutual funds of approved investments". Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk nor concentration of credit risk per GASB Statement No. 40.

Short-term Investment Pool

All short-term funds are held in the State's Short Term Investment Pool (STIP) administered by the Board of Investments (BOI). A summarized description of their disclosure follows and full details may be obtained by contacting the Montana Board of Investments, 2401 Colonial Drive, P.O. Box 200126, Helena, MT 59620-0126.

For STIP securities, BOI's policy specifies that STIP securities have ratings provided by Standard and Poors, Moody's, or Fitch. Obligations of the U.S. government or obligations explicitly guaranteed by the U.S. government are not considered to have credit risk and do not require disclosure of credit quality per GASB Statement No. 40.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE C - INVESTMENT RISK DISCLOSURES, continued

Per the BOI, all STIP securities are registered in the nominee name for the Montana Board of Investments and held in the possession of the Board's custodial bank. The STIP Investment Policy Statement addresses concentration of credit risk by investment category. The STIP had concentration of credit risk exposure to the Federal Home Loan Bank of 6.89%, Federal National Mortgage Association (Fannie Mae) of 7.55 % and the Federal Home Loan Mortgage Corp. (Freddie Mac) of 5.71% as of June 30, 2008. The STIP portfolio, by issuer, had no concentration of credit risk exposure as of June 30, 2007. Per GASB Statement No. 40, interest rate disclosures are not required for STIP since STIP is a 2a-7-like pool.

Under the provisions of state statutes, the BOI has, by a Securities Lending Authorization Agreement, authorized the custodial bank, State Street Bank, to lend BOI's securities to broker-dealers and other entities with a simultaneous agreement to return the collateral for the same securities in the future. During the period the securities are on loan, BOI receives a fee and the custodial bank must initially receive collateral equal to 102% of the fair value of the securities on loan and must maintain collateral equal to not less than 102% of the fair value of the loaned security. BOI retains all rights of ownership during the loan period. At year-end, the BOI had no credit risk exposure.

NOTE D - ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

| | June 30, | |
|--------------------------------|----------------------------|---------------------------|
| | 2008 | 2007 |
| Interest receivable | \$ 7,639 | \$ 17,741 |
| Accounts receivable | 1,650,158 | 1,553,021 |
| Allowance for returned tickets | (245,550) | (189,008) |
| | <u><u>\$ 1,412,247</u></u> | <u><u>\$1,381,754</u></u> |

NOTE E - INVENTORY

Inventory consists of the following:

| | June 30, | |
|-----------------|----------------------------|---------------------------|
| | 2008 | 2007 |
| Scratch tickets | \$ 1,265,494 | \$1,487,491 |
| Supplies | 134,131 | 126,884 |
| | <u><u>\$ 1,399,625</u></u> | <u><u>\$1,614,375</u></u> |

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE F - FURNITURE AND EQUIPMENT

A summary of furniture and equipment for the Lottery is as follows:

| | June 30, 2007 | Additions | Deletions | June 30, 2008 |
|-----------------------------------|-------------------|------------------|-------------------|-------------------|
| Furniture, fixtures and equipment | \$ 421,703 | \$ 133,426 | \$ (15,036) | \$ 540,093 |
| Accumulated depreciation | (282,576) | (43,206) | 12,779 | (313,003) |
| | <u>\$ 139,127</u> | <u>\$ 90,220</u> | <u>\$ (2,257)</u> | <u>\$ 227,090</u> |

NOTE G - INVESTMENTS

Investments of \$139,880 have been recorded this fiscal year as a result of a reclassification of STIP. At June 30, 2008 the STIP balance included investments in Structure Investment Vehicles that were no longer liquid. As a result these investments have been reclassified from cash and cash equivalents to investments.

NOTE H - MULTI-STATE LOTTERY ASSOCIATION (MUSL)

Joint Venture Association - In November 1989, the Lottery joined the Multi-State Lottery Association (MUSL). MUSL was created in September 1987 to operate a multi-state lottery game for the benefit of party lotteries. The Powerball game, Wild Card game and Hot Lotto game are presently the only games operated jointly by the members in which the Lottery participates. Each lottery participating in MUSL is represented on the Board of Directors.

Prize Reserve Fund Receivable/Payable - As a member of the MUSL, the Lottery is required to contribute to various prize reserve funds maintained by MUSL. The contributions are to be used to fund unanticipated prize claims. All funds remitted and the related interest earnings will be returned to the Lottery upon leaving the association, less any portion of unanticipated prize claims, which was paid from the fund.

The Lottery contributes to the reserve fund through the set-aside for prizes. Payments made to the reserve fund are considered a portion of the prize expense associated with each game.

During 1990, the MUSL Board created the unreserved accounts to record interest earned on the various prize reserve funds when the prize reserve fund balance is not below the predetermined ceiling amount. The amounts in the unreserved accounts may be used at the Board's discretion.

The long-term receivable balance of \$1,626,036 and \$1,509,968 at June 30, 2008 and 2007, respectively, represents the Lottery's share of the MUSL prize reserve fund that had a balance of \$127,328,390 and \$119,550,256 for 2008 and 2007, respectively. The long-term liability balance of \$1,094,763 and \$1,105,943 at June 30, 2008 and 2007, respectively, represents the Lottery's share of the total estimated prize liability.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE H - MULTI-STATE LOTTERY ASSOCIATION, continued

Lotto*America Prizes and Investments - Prizes awarded to Lotto*America grand prize winners are paid in twenty annual installments funded by investments in United States Treasury zero coupon bonds. Bonds purchased on behalf of Montana source winners are held in trust by MUSL with the Montana State Lottery as beneficiary. As the bonds mature, the proceeds are forwarded to the Lottery and distributed to the grand prize winners on the anniversary date of each win.

At June 30, 2008 and 2007, MUSL held United States Government zero coupon bonds in trust for the Lottery winners with respective par values of \$22,355,852 and \$29,125,949 and respective market values of \$22,008,985 and \$25,227,505.

The Lottery has eight Lotto*America/Powerball/Tri-West winners. The combined total future prize payments owed is \$24,052,000 and \$29,260,000, at June 30, 2008 and 2007, respectively. The present value of future prize payments approximates the current market value of the bonds held in trust for the Lottery winners.

Total annual payments due as of June 30, 2008 are:

| | |
|------------|---------------------|
| 2009 | \$ 5,208,000 |
| 2010 | 5,106,000 |
| 2011 | 4,603,000 |
| 2012 | 2,155,000 |
| 2013 | 2,155,000 |
| Thereafter | 4,825,000 |
| | <u>\$24,052,000</u> |

Multi-State Lottery Association Financial Position - Information related to the Multi-State Lottery Association's audited financial statements is as follows:

| | June 30, | |
|--|-----------------------|-----------------------|
| | 2008 | 2007 |
| Total assets | <u>\$ 899,702,496</u> | <u>\$ 972,391,954</u> |
| Total liabilities | <u>\$ 899,427,315</u> | <u>\$ 972,194,562</u> |
| Total net assets | <u>275,181</u> | <u>197,392</u> |
| Total liabilities and net assets, unrestricted | <u>\$ 899,702,496</u> | <u>\$ 972,391,954</u> |
| Total revenues | <u>\$ 11,167,862</u> | <u>\$ 14,334,698</u> |
| Total expenses | <u>4,125,761</u> | <u>3,049,852</u> |
| Distributions to party lotteries | <u>6,964,312</u> | <u>11,299,020</u> |
| Increase (decrease) in unrestricted net assets | <u>\$ 77,789</u> | <u>\$ (14,174)</u> |

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE I - ESTIMATED PRIZE LIABILITY

The estimated prize liability represents the Lottery's estimate of prizes payable related to games in process at year-end based on the predetermined prize structure of each outstanding game.

NOTE J - OBLIGATION TO TRANSFER FUNDS

The Lottery is required to transfer its net revenue to the Montana State General Fund. This change was enacted through the passage of SB 83 by the 1995 Legislature and signed into law by Governor Racicot in April 1995. Transfer obligations outstanding at June 30, 2008 and 2007 were \$2,282,998 and \$2,853,513, respectively.

NOTE K - LEASES

The Lottery leases its office, administrative and warehouse facilities under a non-cancelable lease agreement that is effective September 2007 through August 2017. Rent expense under operating leases charged to operations was \$116,979 and \$91,511 for the years ended June 30, 2008 and 2007, respectively.

The future minimum lease payments under operating leases that have remaining terms in excess of one year as follows:

| | |
|------------|--------------------|
| 2009 | \$ 124,937 |
| 2010 | 128,685 |
| 2011 | 132,546 |
| 2012 | 136,522 |
| 2013 | 140,618 |
| Thereafter | 632,449 |
| | <u>\$1,295,757</u> |

NOTE L - EMPLOYEE BENEFIT PLANS

Pension Plan - The Lottery participates in the Public Employees Retirement System (PERS). PERS is a statewide mandatory cost-sharing multiple employer retirement plan which covers all employees. The plan is established under State law and is administered by the State of Montana. The plan provides disability and death benefits to plan members and beneficiaries as well as a choice of a defined benefit or a defined contribution retirement plan.

The plan issues a publicly available financial report that includes financial statements and required supplementary information. The report may be obtained from the following address: Public Employees Retirement System, Montana Public Employees Retirement Administration, P.O. Box 200131, 100 N. Park, Suite 220, Helena, MT 59620-0131, (406) 444-3154.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE L - EMPLOYEE BENEFIT PLANS, continued

The contribution rate for the plan is required and determined by State law. The contribution rate for fiscal year 2007, expressed as a percentage of covered payroll, was 6.9% for both the employer and the employees. In fiscal year 2008 the employer rate increased to 7.035% and the employee rate remained at 6.9%. The amounts contributed to the plan by the employer during the years ended June 30, 2008 and 2007, were \$89,150 and \$83,045, respectively, and were equal to the required contributions for each year.

Deferred Compensation Plan - The Lottery's full-time regular employees are eligible to participate in the State of Montana's deferred compensation plan. The plan is administered by Benefits Corporation on behalf of Great West Life Insurance Company through a contract with the State of Montana. The amount of compensation deferred is not available to employees until termination, retirement, death, or unforeseen emergency. All amounts are deferred under the plan created under Internal Revenue Code Section 457 and Title 19, chapter 50, Montana Code Annotated (MCA). Assets of the deferred compensation plan are required to be held in trusts, custodial accounts or insurance company contracts for the exclusive benefit of participants and their beneficiaries.

NOTE M - RELATED PARTY TRANSACTIONS

During the ordinary course of business, other State agencies provide certain services and supplies to the Lottery. During 2008 and 2007, total payments to other State agencies were approximately \$213,743 and \$174,219, respectively.

NOTE N - COMMITMENTS, CONTINGENCIES AND SUBSEQUENT EVENT

Scratch Tickets - The Lottery has an agreement with Scientific Games, Inc. to print scratch game tickets. The contract expires August 8, 2008. The Lottery incurs approximately \$900,000 per year under this contract.

Terminal Vendor - The Lottery is contracted with Intralot, Inc to provide for the operation of the gaming system through March 30, 2016. The contract price is 5.8% of each \$1 ticket sold, which is an estimated total contract price of approximately \$17 million over the seven-year contract. The contract price includes the cost of equipment.

Advertising - The Lottery signed a contract with Banik & Associates to provide advertising services for \$5,500 per month through December 2007 and extended through June 30, 2008.

Independent Observation of Drawings - The Lottery is committed to Galusha, Higgins and Galusha, PC, to observe Montana Cash and other special drawings. The original term of the contract was for three years ending June 30, 2005. The contract was renewed for a three year period ending June 30, 2008. Compensation did not exceed \$32,000 for the three year period.

Continued

Montana State Lottery
NOTES TO THE FINANCIAL STATEMENTS
June 30, 2008 and 2007

NOTE N - COMMITMENTS, CONTINGENCIES AND SUBSEQUENT EVENT, continued

Audit of Financial Statements - The Lottery is party to a contract with Galusha, Higgins and Galusha, PC, an independent accounting firm, to audit the Lottery's annual financial statements. The yearly contract was finalized on June 30, 2008. Amounts paid to Galusha, Higgins and Galusha, PC for the June 30, 2008 audit will not exceed \$13,500 and amounts paid for the June 30, 2007 audit did not exceed \$12,000.

NOTE O - RISK MANAGEMENT/PUBLIC ENTITY RISK POOL

The Lottery contributes to the Group Employee Comprehensive Medical and Dental Plan and the Property and Casualty Insurance plans of the State of Montana. Details of these plans can be found in the State of Montana Comprehensive Annual Financial Report available through the Department of Administration's website at www.mt.gov/doa/afsd/cafr/cafr.asp.

NOTE P - OPEB (OTHER POST EMPLOYMENT BENEFITS)

Effective for the year ended June 30, 2008, Governmental Accounting Standards Board (GASB) Statement 45 and the reporting requirements for the "implied rate subsidy" required the State of Montana to book substantial liabilities. The liability is a result of the state's requirement to allow retired employees to remain in the health insurance plan after retirement. This results in an implicit rate subsidy since retirees pay the same amount as active employees. "Actuaries Northwest" prepared the report for the State of Montana to calculate the Annual Required Contribution under the GASB. The allocation was then made based on 2008 benefits expense and the number of full time employees for an agency. The amount calculated for the year ended June 30, 2008 for the Lottery is \$104,369. Additional information will be available in the State's Comprehensive Annual Financial Report (<http://accounting.mt.gov/cafr/carf.asp>).

Concluded



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INDEPENDENT AUDITOR'S REPORT ON INTERNAL CONTROL OVER FINANCIAL
REPORTING AND ON COMPLIANCE AND OTHER MATTERS BASED ON AN
AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH
GOVERNMENT AUDITING STANDARDS

Board of Directors
Montana State Lottery
Lottery
Helena, Montana

We have audited the financial statements of Montana State Lottery, as of and for the year ended June 30, 2008, and have issued our report thereon dated November 17, 2008. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

Internal Control over Financial Reporting

In planning and performing our audit, we considered Montana State Lottery internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

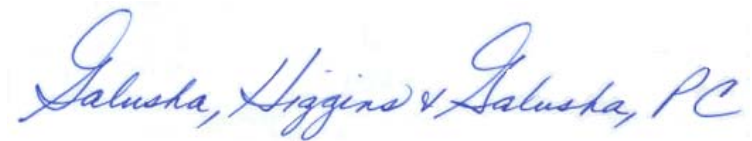
Board of Directors
Montana State Lottery

Our consideration of the internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance

As part of obtaining reasonable assurance about whether Montana State Lottery financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations and contracts, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under *Government Auditing Standards*.

This report is intended solely for the information and use of the audit committee, management, and others within the Montana State Lottery, and is not intended to be and should not be used by anyone other than these specified parties.

A handwritten signature in blue ink that reads "Galusha, Higgins & Galusha, PC". The signature is written in a cursive, flowing style.

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors

Helena, Montana
November 17, 2008

OTHER ENCLOSURES

Montana State Lottery

June 30, 2008 and 2007



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November 17, 2008

File: 41.9262
6/30/08

Montana State Lottery Commission
Helena, Montana

This letter is intended to inform the Montana State Lottery Commission about significant matters related to the conduct of the annual audit so it can appropriately discharge its oversight responsibility and that we comply with our professional responsibilities to the Montana State Lottery Commission.

The following summarizes various matters which must be communicated to you under auditing standards generally accepted in the United States of America and *Government Auditing Standards*.

The Auditor's Responsibility Under Auditing Standards Generally Accepted in the United States of America

Our audit of the financial statements of the Montana State Lottery (the Lottery) for the year ended June 30, 2008 was conducted in accordance with auditing standards generally accepted in the United States of America and *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error, fraudulent financial reporting or misappropriation of assets. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Accordingly, the audit was designed to obtain reasonable, rather than absolute, assurance about the financial statements. We believe that our audit accomplished that objective.

In accordance with *Government Auditing Standards*, we have also performed tests of controls over internal control over financial reporting and tests of compliance with certain provisions of laws, regulations, contracts, and grant agreements that contribute to the evidence supporting our opinion on the financial statements. However, they do not provide a basis for opining on the Lottery's internal control over financial reporting or on compliance and other matters.

Management Judgments and Accounting Estimates

Accounting estimates are an integral part of the preparation of financial statements and are based upon management's current judgment. The process used by management encompasses their knowledge and experience about past and current events and certain assumptions about future events. Management has informed us they used all the relevant facts available to them at the time to make the best judgments about accounting estimates and we considered this information in the scope of our audit. Estimates significant to the financial statements include the allowance for returned tickets of \$245,550. The Commission may wish to monitor throughout the year the process used to compute and record these accounting estimates.

RSM McGladrey Network
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Audit Adjustments

There were no audit adjustments made to the original trial balance presented to us to begin our audit.

Uncorrected Misstatements

We accumulated no uncorrected misstatements (passed adjustments).

Accounting Policies and Alternative Treatments

Management and the Commission have the ultimate responsibility for the appropriateness of the accounting policies used by the Montana State Lottery. The Lottery did not adopt any significant new accounting policies nor have there been any changes in existing significant accounting policies during the current period which should be brought to your attention for approval.

We did not identify any significant or unusual transactions or significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

Disagreements with Management

We encountered no disagreements with management over the application of significant accounting principles, the basis for management's judgments on any significant matters, the scope of the audit or significant disclosures to be included in the financial statements.

Consultation with Other Accountants

We are not aware of any consultations management had with other accountants about accounting or auditing matters.

Major Issues Discussed with Management Prior to Retention

No major issues were discussed with management prior to our retention to perform the aforementioned audit.

Difficulties Encountered in Performing the Audit

We did not encounter any difficulties in dealing with management relating to the performance of the audit.

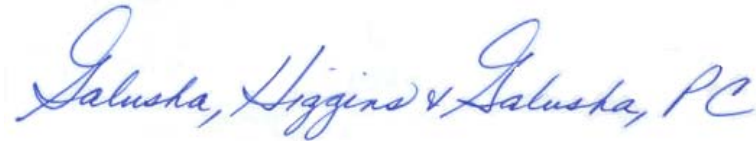
Closing

We will be pleased to respond to any questions you have about the foregoing. We appreciate the opportunity to continue to be of service to the Montana State Lottery.

* * * * *

This report is intended solely for the information and use of the Commission Members, Directors and management and is not intended to be and should not be used by anyone other than the specified parties.

Very truly yours,

A handwritten signature in blue ink that reads "Galusha, Higgins & Galusha, PC". The signature is written in a cursive, flowing style.

GALUSHA, HIGGINS AND GALUSHA, PC
Certified Public Accountants and Advisors